NBP Fullerton Asset Management Ltd.
A Subsidiary of National Bank of Pakistan

Interest Rates Outlook

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The State Bank of Pakistan has recently reduced the discount rate by 150 basis points. We will discuss the implications of this decision on the economic and investment climate of the country. First of all, there is no question that lower interest rates are good for any country. They encourage investors to borrow more to expand business resulting in reduced unemployment, higher corporate profitability, and growth of the economy. However, lower interest rates are only sustainable and productive in a low inflation environment. Otherwise, they encourage consumption rather than savings and investments that feed inflation. Pakistan's savings and investment rates as a percentage of GDP are already the lowest among the emerging markets. It is important to note that the discount rate has been brought down to 10.5% per annum, whereas the core inflation is still above 11% per annum.

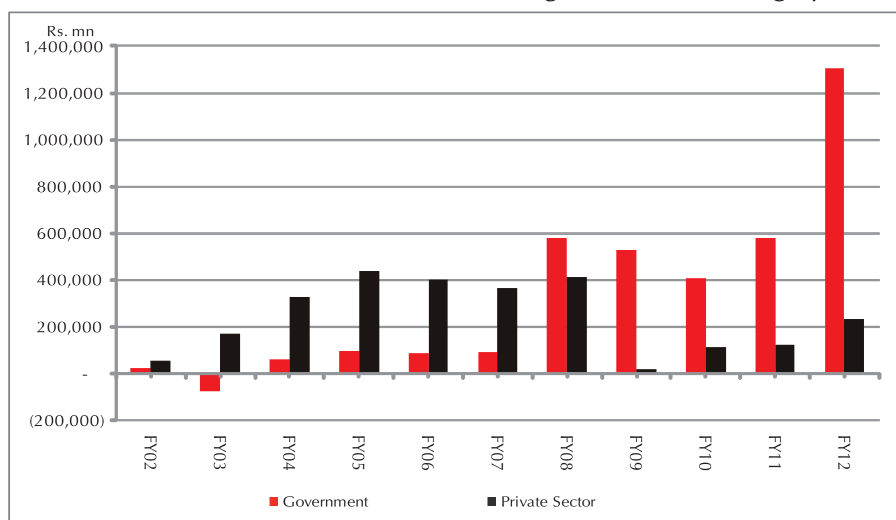
Lower inflation and lower interest rates are only sustainable if the government reduces borrowing, which can only be done by taxing all sources of income and reduction in government expenditures. We have not seen any concrete steps in this direction. Net domestic assets of the banking system have grown by 20% over the last 12 months, and Government borrowing from the State Bank has risen by 22% during the same period. Budget deficit as a percentage of GDP is expected to be a phenomenal 9% in this fiscal year. Moreover, international oil prices are on the rise. In this scenario, we expect that inflation will rise in the near future and the State Bank of Pakistan is expected to reverse its decision of easing the monetary policy stance, and will thus increase the discount rate in about six months time period.

Reduction in the discount rate, though expected to be a temporary phenomenon, will give some respite to corporates that carry significant amounts of debt in their books. Return on bank deposits, National Savings Schemes and money market funds have declined by about 1% to 2% following the reduction in discount rate, which will negatively impact the depositors / investors. The stock market welcomed the decision and has risen by over 4% since the announcement.

The risks of dollarization, flight of capital and currency devaluation have increased due to reduction in the discount rate. I try to explain this point with an example. Assume that an investor can earn 13% p.a. on rupee investment in say T-bills, and 2% p.a. on a US dollar account in a bank. Assume that his / her expectation of devaluation of the rupee versus the US dollar is 10% during the year. His total return on the US dollar if the rupee devalues as per his / her expectations will be 12% p.a. (2% dollar return plus 10% devaluation benefit). He or she is better off keeping his / her investment in the Pakistani rupee where he / she is earning 13% p.a. Now assume that the return of the investor on rupee investment declines to 10% p.a. due to reduction in the discount rate by the State Bank of Pakistan. His expectations of devaluation of the rupee versus the US dollar and return on the US dollar remain the same as before. His total return on the US dollar account if his expectations are met will be the same 12% p.a. as before. However, his return on the Pakistani rupee now will be 10% p.a.. He will now prefer to keep his savings in US dollars either within Pakistan or outside Pakistan rather than in the rupee. Also, such a dollarization drive will compound the depreciation of the rupee versus other currencies. Thus, for a country experiencing high inflation, high budget & current account deficits, and muted FDI and FPI inflows, lowering of interest rates carries a high risk of currency devaluation and flight of capital.

The argument that reduction in interest rates will help grow the economy is also a weak proposition. This is because lower interest rates will not improve private investments due to the crowding-out effect. This is due to the fact that the government uses a large share of the available money supply, leaving very little room for the private sector to borrow and expand (see chart below). Thus, as long as the government does not reduce its borrowing appetite the economic growth rate will not rise substantially despite lower interest rates. Considering the risk of rise in interest rates, investors are advised to invest in floating-rate rather than fixed-rate instruments, and keep the maturity of their investments relatively short.

Government vs Private Sector Borrowing from the Banking System



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